3.06 Adjusted Cost Method

No Significant Influence – Measurement

Initial Measurement

When an investor has neither a controlling financial interest (consolidated) nor the ability to exercise significant influence over the activities of the investee (equity method), the investor will initially record the investment at cost.

Fair Value Method

In most cases, it will then be adjusted to its fair value (Fair Value Method) on each balance sheet date with both realized and unrealized gains/losses recognized in income. Realized gains/losses, of course, will be adjusted for any portion that may have been reported in a prior period as an unrealized gain/loss. This is similar to the trading securities approach previously discussed.

When market value is not readily determinable, the entity will determine if it is eligible to measure fair value using a practical expedient. It involves using the published fair value of net assets per share, or equivalent amount, multiplied by the number of shares/units held. This approach can be used only when the fair value per share is calculated in accordance with ASC 946, *Financial Services—Investment Companies*.

Adjusted Cost Method

If the investment also does not qualify to be measured by applying the practical expedient, the entity may elect to report it at an amount equal to its cost minus any impairment losses (we call this the "Adjusted Cost Method") that have been recognized and adjusted for any changes resulting from observable price changes.

- The entity is required to make a qualitative assessment every reporting period, evaluating impairment indicators to determine if the investment is impaired. Examples of impairment indicators are provided in the Impairments discussion below.
- An observable price change occurs when there is an orderly transaction involving an identical security or a similar security of the same issuer.
- Once elected, the investment continues to be accounted for in that manner until it no longer qualifies to use it.
  - This will occur when either the market value becomes readily determinable or when it becomes eligible for the practical expedient. Additionally, the investor may gain the ability to exercise significant influence over the investee, at which point the equity method would be appropriate, applied on a prospective basis.
  - As long as this approach is in use, the entity is required to reassess whether the investment continues to qualify to use this measurement every reporting period.

Impairments

Each reporting period, the entity is required to perform a qualitative analysis to determine if there is an indication that the investment has been impaired. The qualitative evaluation will look for circumstances that might adversely affect the investee, such as:

- A deterioration in earnings, financial position, credit rating, asset quality, or business prospects
- Changes in the regulatory, economic, or technological environment
- Changes in the market conditions relevant to the entity's geographical area or industry
- A bona fide offer to purchase the entity, or a completed auction process, for less than the carrying amount of the net investment
- Factors affecting the investee's ability to continue as a going concern

When there is such an indication, the entity will determine if an estimate of the fair value is lower than the carrying value, in which case an impairment loss is recognized. The impairment loss reduces the carrying value of the investment and is reported in the *current period's income*. The impairment loss may be recovered as more information is obtained and the securities are adjusted back upward to fair value.

As is true for all investments in equity securities that are not required to be accounted for via consolidation or the equity method, dividend income from investments in equity securities is reported in income.

- The original investment is recorded at cost.
- When the investee earns money, no journal entry is recorded.
- When a dividend is received, it is recorded as Dividend Income on the income statement (not a reduction of the Investment).
  - In rare cases, if the dividend received is greater than the investor's proportionate share of the investee's income since acquisition, then it is recorded as a reduction of the investment (these usually are distributions of an investee's earnings that occurred BEFORE the investor made their purchase of the investee).

Cash	X	
Investment		X

- No difference between BV and purchase price is taken into consideration (no excess amortization or depreciation as in the equity method).

Disclosures

Disclosures for equity investments accounted for under this approach when the fair value is not readily determinable will include:

- The carrying amount of the investments
- Impairment losses, if any, both for the current period and on a cumulative basis
- Upward adjustments to the investment, both for the current period and on a cumulative basis

- Considerations applied in determining the carrying amounts of the investments, upward or downward adjustments, and additional information the entity considers necessary to enable users to understand the qualitative disclosures

Notice that while the investor's share of the investee net income is $120 × 30% = $36, only the dividend received of $40 × 30% = $12 is recorded in income. The reason for the difference in the handling of income and dividends is the difference in the relationship between investor and investee under each circumstance.

- Since the equity method is used when the investor has the ability to exercise significant influence over the activities of the investee, it is assumed that the investor could convince the investee to distribute more, or even all, of its income in the form of dividends. This is considered an application of the accrual method.
- When the investor *does not* have the ability to exercise such influence, it has no assurance that it will receive any dividends beyond those which have been declared. Although this is not consistent with the accrual method, it is not considered a departure since accrual of a receivable that is not necessarily probable would be considered inappropriate.

In general, dividends from investments in equity securities are reported as income. This would not be true, of course, if the investee is a consolidated subsidiary, in which case dividends from the subsidiary to the parent are eliminated. Nor would it be the case under the equity method, where the investor reports its entire share of investee income as an increase in the investment, and distributions of dividends reduce the investment.

When dividends are received from investments that are either reported at fair value or via the adjusted cost method, however, they are generally reported as income.

Dividends received, however, are not always distributions of income to the investor. If the investee declares dividends that exceed the cumulative income it has earned since the date of the investment, the excess distribution is a return of capital to the investor, and is accounted for as a reduction in the carrying value of the investment.

For example, if the investee declares a dividend of $450, and the income earned since the investment date is only $400, the entry on the dividend record date by a 10% investor would have been:

Dividends receivable	45	
Dividend income		40
Investment		5

If an investee declares a stock dividend or issues stock rights or other classes of stock to existing shareholders, no income is reported. Instead, the carrying value of the investment is simply allocated over the increased quantity of securities.

- If the securities are all of the same class, no entry is needed, and the number of shares is disclosed in the notes to the financial statements, if material.
- If the new securities are in a different class, an entry is made to transfer part of the carrying value, using the relative fair value approach.

For example, assume a client purchased 100 shares of stock at a price of $22 per share, or a total cost of $2,200:

Investment in stock	2,200	
Cash		2,200

If the investee declares a 10% stock dividend, then the number of shares held by the investor will increase to 110, but no entry is made. Instead, the $2,200 is allocated over 110 shares, so that the cost basis of each share becomes $20.

If, instead, the investee issues a stock right for each existing share, and the fair value of the stock and the stock rights on the record date are $24 per share and $6 per right, respectively, then the rights will be allocated 6 / (24+6) = 20% of the carrying value of the securities:

Investment in rights	440	
Investment in stock		440

No income is reported on dividends in arrears on cumulative preferred stock under the cost method, since this represents dividends that have not been declared. Only once they are declared and the date of record is reached can they be reported in the investor's records as dividend income.

The purchase of life insurance on an officer can be a form of investment when it builds up a cash value (cash surrender value). The portion of the premium that increases the cash value is accumulated as an asset (noncurrent asset) on the balance sheet, and the rest of the premium is recognized as life insurance expense. If the officer dies, the proceeds from the policy are recognized as income only to the extent they exceed the cash value.

Dividends on life insurance are treated as reductions of the net premium cost and are not reported as dividend income.

Equity	Adjusted Cost
1) Buy	
Investment 1,000 ($750 BV + $150 PP&E + $100 GW) Cash 1,000	Investment 1,000 Cash 1,000
2) Investee earns money	
Investment 36 (120 × 30%) Equity in Earnings 36 EIE = I/S (N) section – Not cash ⇒ back out in cash flow	No journal entry

3) Pay a dividend	
Cash 12 (40 × 30%) Investment 12	Cash 12 Dividend Income 12 DI = I/S (N) section
4) Amortization/depreciation/impairment of excess	
Purchase $1,000 Goodwill = 1,000 – 900 FV 900 = 100 BV 750 Impairment = $10 Depreciation = 900 – 750 150/10 yrs = $15 = $25 Equity in Earnings 25 Investment 25 Taking out amortization/depreciation/impairment	No journal entry
*Investment follows equity balance of investee.	*No change to Investment.

Changes in Ownership Percentages

There are a variety of ways in which an investor may gain the ability to exercise significant influence over the investee. The investor may do so by acquiring additional shares of the investee's stock; as a result of the retirement of shares by the investee; by establishing a significant business dependency, such as becoming a significant customer or supplier; or by obtaining greater representation in the investee's governance.

When an investor *gains the ability* to exercise significant influence over the activities of an investee, the investment qualifies for the equity method and it is required to be applied prospectively.

- The carrying value of the investment is not adjusted.
- The cost of additional shares of the investee acquired by the investor, if any, is added to the carrying value of the investment.
- The equity method of accounting is applied to the investment from that point forward, using the percentage of the investee that is owned by the investor

An investor entity may also *lose the ability* to exercise significant influence over the activities of the investee. This may result from the disposal of a portion of the investment; the issuance of additional shares by the investee, reducing the investor's ownership percentage; the termination of a business dependency, such as discontinuing being a significant supplier or customer; or by reducing the investor's representation in governance.

When an investor loses the ability to exercise significant influence over the activities of the investee, it no longer qualifies for use of the equity method of accounting for the investment. The investor will:

- Apply the equity method up until the date on which the investment no longer qualifies for its use.

- The carrying value of the investment is considered its new cost.
- The investor applies the appropriate method other than the equity method:
  - If the market value of the investee is readily determinable, the investment will be adjusted to its fair value on each balance sheet date with unrealized gains and losses reported in earnings for the period.
  - If the market value of the investee is not readily determinable, the investor may elect the adjusted cost method and so indicate in the summary of significant accounting policies.

In all cases, the change in methods is applied prospectively.

Fair Value Option

As previously discussed, ASC 825, *Financial Instruments*, includes a provision that allows an entity to choose to report almost any of its financial instruments, including both its financial assets and financial liabilities, at fair value. This is referred to as the fair value option and may be applied to eligible financial instruments (eg, receivables, payables, derivatives, securities, etc.) on specified election dates on a security-by-security basis and may be applied to some or all of a group of securities.

The election dates on which an entity may elect the fair value option include:

- When the eligible item is first recognized.
- When an eligible firm commitment is entered into.
- When items previously presented at fair value due to specialized accounting principles, with unrealized gains or losses recognized in earnings, no longer qualify for the specialized accounting principles.
- When an investment becomes subject to the equity method.
- When an item is required to be measured at fair value on a one-time basis but is not required to be adjusted to fair value on subsequent financial statement dates.

On a given election date, the entity may elect to report the item or items at fair value or may apply the election to only some of the items, with the decision being made on a *security-by-security basis*.

- An entity with numerous firm commitments may elect to report some, all, or none of them at fair value.
- An entity with several investments accounted for under the equity method may elect to report some, all, or none of them at fair value.

Once made, a fair value election is irrevocable. It may, however, be changed on a subsequent election date. When the fair value option election is made, the eligible item will be measured at its fair value on each balance sheet date. Any unrealized gains or losses will be recognized as a component of income. If the fair value option election were applied to:

- An equity method investment, it would be measured at fair value on each balance sheet date and any changes, net of dividends received, will be recognized as a gain or loss.
- An available for sale (AFS) investment in debt securities, will be reported at the same value as before the election but the unrealized gains and losses will be reported as a component of income rather than other comprehensive income.
- A held to maturity (HTM) investment in debt securities, it would continue to be accounted for under the amortized cost method, applying the effective interest method, but after

amortization of discount or premium, the carrying value will be increased or reduced to fair value at the balance sheet date and the unrealized gain or loss will be recognized in income.

- A firm commitment, such as a foreign currency forward exchange contract, an asset or liability would be recognized at fair value as the subject of the commitment, such as the foreign currency exchange rate, changes.